



## MESSAGE FROM THE PRESIDENT

With a mandate to promote maximum sustainable economic growth as well as stable prices, Fed policymakers must be constantly vigilant. When the economy gathers strength and overcomes a ‘soft patch’ or recession, inflation concerns typically become more pressing. Such was the case in 2004.

The economy entered the year with significant momentum, thanks in part to a highly accommodative monetary policy put in place to help foster a recovery from the 2001 recession. With this momentum, the economy’s vitality spread into areas that had struggled in the previous two years – specifically the manufacturing sector and labor markets.

With that in mind, the Federal Open Market Committee (FOMC) during 2004 sharpened its focus on inflation. Prices for many commodities increased during most of the year, but none drew as widespread attention as oil prices. The price for a barrel of West Texas Intermediate crude (the bellwether of energy prices) topped \$55 in October – well above the \$30 average that persisted between 2000 and 2002. As 2004 progressed, core inflation measures moved up from the extremely low rates in late 2003.

Even though the uptick in inflation was widely viewed as temporary and inflation expectations remained contained, it became clear that the highly accommodative monetary policy that had been needed earlier in the recovery



was no longer necessary. As a result, the FOMC began to remove its policy accommodation. Beginning in June 2004, we increased our target for the federal funds rate from 1 percent and eventually pushed the rate to 2.75 percent in March 2005.

Even with tighter monetary policy, the economy continued to expand in 2004. Manufacturing production grew at the fastest rate in five years, and payroll employment increased in all 12 months of the year for the first time since 1999. By early 2005, both production and employment surpassed the

level of their previous peaks, a sure sign that the economy had shifted from recovery mode to expansion.

#### Community Banks Play Important Role in Regional Economy

In this year’s annual report, we are taking a close look at community banking. Because of the services they provide small businesses, farms and households, community banks play an important role in the economy of the Seventh

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Federal Reserve District (Iowa and most of Illinois, Indiana, Wisconsin and Michigan). We're home to more community banks than any of the other 11 Fed districts.

An essay starting on page 7 offers a comprehensive look at the current state of community banks in the U.S. It explains why community banks are unique, documents the reasons for their declining numbers in recent years, and offers a perspective on what they must do to be competitive moving forward. The conclusion is that in a constantly changing environment, with fierce competition from a wide variety of other financial services providers, those community banks that are well-run and efficiently managed will not only survive, but thrive.

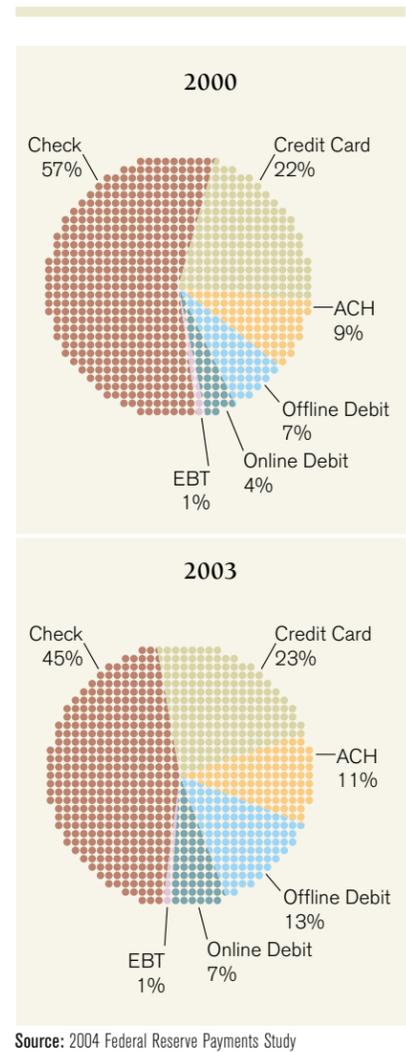
**Electronic Payment Growth Forces Check-Processing Consolidations**

Another issue we're watching closely is the continued growth of electronic payments. Consumers continue to move away from paper checks (See chart at right). A recent Federal Reserve payment study confirms that U.S. electronic payment transactions in 2003 exceeded check payments for the first time. Between 2000 and 2003, check payments declined an average of 4.3 percent, while electronic payment transactions jumped an average of 13.2 percent.

While the shift is beneficial to the payment system, it has had a profound impact on our check-processing operations. We are consolidating Federal Reserve check-processing facilities across the country. By early next year, the number of check-processing sites will have decreased from 45 to 23. Of all the restructuring throughout the Federal Reserve System, the most took place in the Seventh District. For example:

- The Omaha check-processing office closed in April of 2004, with the Chicago Fed's Des Moines office picking up the volume.
- In July of 2004, the Chicago Fed's Milwaukee office closed. Those checks transferred to the Chicago Midway office, where we expanded our capacity to handle additional volume.

**Non-Cash Payments in 2000 and 2003**



- The Chicago Fed in October of 2004 closed its Peoria office in central Illinois, with that volume shifting to the Chicago Midway office.
- The Chicago Fed's Indianapolis office also closed in October of 2004, with that volume shifting to the Cincinnati office.
- In addition, checks being processed at our Detroit branch are slated to transfer in mid-April of 2005 to the Cleveland office.

Despite this much restructuring, our staff continued to provide high-quality check services to our customers. I'm pleased to say the consolidations have gone very well. Our check-processing operations are now more efficient, with costs more in line with revenue. Our Chicago Midway office is processing roughly 3 million checks a day. Overall, more than 2 billion checks were processed in the Seventh District in 2004, with the Check Department achieving local net revenue financial targets.

We will monitor trends in the payments industry, and we're confident we are structured to provide efficient, high-quality service for years to come.

**Other 2004 Accomplishments**

Other notable accomplishments in 2004 include the work of our Customer Relations and Support Office (CRSO), which serves the entire Federal Reserve System. Despite a

tight deadline and technology challenges, the CRSO rolled out Fedline Advantage, which allows customers to conduct high-value, high-risk transactions securely via the Web.

In Supervision & Regulation (S&R), Senior Vice President Cathy Lemieux was promoted in November to lead the department. Throughout the year, S&R continued to improve its risk assessment process by focusing on risk identification, analysis and resolution. We carried out roughly 1,100 examinations, inspections and off-site reviews and also offered training to almost 600 directors of community banks.

Economic Research also had an outstanding year in its effort to produce innovative research that leads to the development of informed public policy. The Research Department had more articles (21) selected to be included in scholarly publications than in any of the 10 years I have been at the Bank.

Work was also completed at our downtown Chicago headquarters on a comprehensive set of building improvements to enhance security and ensure employee safety. In addition, progress

continued on construction of our new Detroit Branch building (See photo), slated to open in January 2006 with improved security and an expanded, state-of-the-art cash vault.

Looking at operations across the board, support and overhead costs in the Seventh District were 10% below budget in 2004 without impacting service levels or incurring any undue risk. We also made significant progress in enhancing internal controls.

These are just a few of our 2004 highlights. I invite you to look over a more comprehensive listing starting on the next page. These would not have been possible without the dedicated commitment of our staff members who remained productive and focused through a challenging year.

**Thanks to our Directors**

Commitment is also a good word to use when discussing the two teams of directors who provide us with perspective, guidance and counsel. I'd specifically like to thank the directors who retired at the end of 2004: James H. Keyes and Alan R. Tubbs from the Chicago board and Robert E. Churchill from the Detroit board. Their contributions are very much appreciated.

In 2005, we welcomed three new members to our boards. Joining our Chicago board are Mindy C. Meads, CEO of Lands' End, Inc. and executive vice president at Sears, Roebuck and Co., and Jeff Plagge, president and CEO of The First National Bank of Waverly in



A model of the new Detroit Branch currently under construction and slated to open in January.

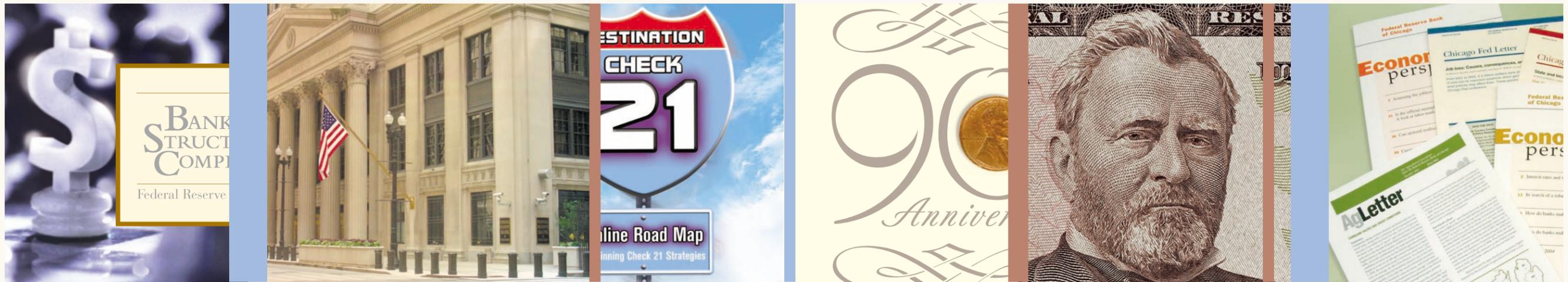
Waverly, Iowa; president of the First of Waverly Corporation; and CEO of the First National Bank of Cedar Falls and First Insurance Services. Joining the Detroit board is Michael M. Magee, Jr., president and CEO of Independent Bank Corporation in Ionia, Michigan.

I am personally very thankful for the contributions of our directors. With their hard

work and that of our staff, we are well positioned to continue our efforts in 2005 to foster a strong economy and a stable payment system.

Michael H. Moskow  
President and Chief Executive Officer  
April 1, 2005

## CHICAGO FED HIGHLIGHTS OF 2004



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## First Quarter

- Supervision and Regulation starts a successful year in which roughly 1,100 examinations, inspections and off-site reviews were conducted.
- Groundbreaking is held at the site of the Bank's new Detroit Branch building, which is slated to open in January 2006.
- A new and improved Web site offers users more efficient access to Chicago Fed information.
- The Bank and Junior Achievement host a job-shadow day for high school students, one of numerous volunteer activities for employees throughout the year.
- The Cash Department kicks off a year in which operational performance is improved and internal controls enhanced.

## Second Quarter

- Supervision and Regulation continues efforts to improve its risk assessment process focusing on risk identification, analysis and resolution.
- Chicago Fed President Michael Moskow appears on CNBC-TV's *Squawk Box*, one of his more than 25 public appearances in 2004 to discuss banking and economic issues.
- Significant progress is made during the year toward implementing a comprehensive risk management framework and strengthening internal controls.
- The Bank hosts its 40th annual Conference on Bank Structure and Competition. Titled, *How Do Banks Compete? Strategy, Regulation, and Technology*, it is one of 29 research and public policy conferences conducted throughout the year. (1)
- Supervision and Regulation starts community bank director training sessions throughout the Seventh District. During the year, more than 600 directors are educated about regulatory compliance and other supervisory issues.
- The Bank sponsors a *Money Smart Week* in both Chicago and Detroit to inform consumers about managing their personal finances.
- A public hearing takes place at the Chicago Fed on the proposed merger of Bank One and J.P. Morgan Chase & Co.
- Roughly 70 leaders from across the Federal Reserve System attend the first segment of a two-part Senior Leadership Conference sponsored by the Chicago Fed.
- As part of a national consolidation of check-processing facilities, the Omaha check-processing office closes, with volume shifting to the Chicago Fed's Des Moines office.
- People Practices' Gene Mysliwicz, the Bank's longest-tenured staff member, retires after 49 years of service.
- Staff celebrates the 90th anniversary of the Bank's incorporation. Later in the year, the Chicago Fed celebrates the 90th anniversary of when it opened for business. (4)

## Third Quarter

- Work continues at Chicago headquarters on a comprehensive set of building improvements carried out throughout the year to enhance security and ensure employee safety. (2)
- As part of a national consolidation of check-processing facilities, the Milwaukee office closes, with volume shifting to the Chicago Midway office. Construction at Midway is completed to make room for additional processing equipment.
- Work progresses on management of the Federal Reserve's national financial services marketing efforts being centralized in the Bank's Customer Relations and Support Office, improving effectiveness and reducing costs.

## Fourth Quarter

- Economist Bhashkar Mazumder examines sibling similarities, differences and economic inequality in one of 30 working papers published by Economic Research during the year.
- Redesigned \$50 bills, containing enhanced security features, are distributed to financial institutions. (5)
- Students from St. Charles North High School in St. Charles, Illinois tour the Bank's Visitors Center, part of a record 21,000 who visited the center in 2004.
- Economic Research hosts its seventh annual International Finance and Economics Conference, *Systemic Financial Crises: Resolving Bank Insolvencies*.
- New Check 21 legislation takes effect, with the Fed educating customers and offering related products and services. (3)
- The Bank's Customer Relations and Support Office introduces Fedline Advantage – enhanced Web technology offering financial institutions more efficient ways to use critical payments services such as Fedwire Funds, Fedwire Securities and FedACH.
- Part of a national consolidation of check-processing facilities, the Peoria and Indianapolis offices close, with volume shifting to the Chicago Midway and Cincinnati offices respectively.
- Economic Research publishes 16 articles in the Bank's *Economic Perspectives*, 12 issues of *Chicago Fed Letter*, seven special editions of *Chicago Fed Letter*, four issues of *AgLetter*, and monthly editions of the CFNAI and CFMMI data releases. (6)
- More than 2 billion checks are processed in the Seventh District throughout the year, with the Check department achieving local net revenue financial targets.
- Support and overhead costs in the Seventh District drop 10 percent in 2004 without impacting service levels or incurring any undue risk.
- Throughout the year, Economic Research has 21 papers accepted for publication in scholarly journals.

## COMMUNITY BANKS AT THEIR BEST

Serving Local Financial Needs

As the population of community banks continues to decline, some worry that this most traditional of U.S. financial institutions might no longer be viable. But a careful look at the data doesn't square with a path to extinction. Instead, the evidence suggests a process of natural selection in which well-run community banks will thrive.

By Robert DeYoung  
Senior Economist and Economic Advisor

*Large banks are everywhere. You've paid them more attention lately, especially since they set up shop in your town by buying local banks and changing the signs. They advertise during all the football games you watch on television, and some of the arenas are even named after them. And they always seem to be opening new branches – near your office, in your supermarket, and next to your shopping mall. In fact, following the lead of several tony Chicago suburbs, your town council is considering an ordinance that would ban any new bank branches from opening on Main Street.*

*But there are still small banks in your town. One community bank has been there as long as you can remember. You don't need a TV commercial to remind you, because you've driven or walked past it nearly every day of your life. It's where your parents took you to open your first savings account, and where you received the mortgage to buy your first home. It finances your neighbor's business and your brother's farm, and it manages your parents' retirement investments. No one would dream of banning this bank from Main Street.*



**What is a Community Bank?**

The word “community” infers a smallness and a connect- edness – but a separateness as well. From Webster’s Dictionary, a community is “a group of people with a common characteristic or interest living together within a larger society.” Community banks serve the financial needs of community residents – local businesses and households – so that they can make their own unique contributions to the larger economy.

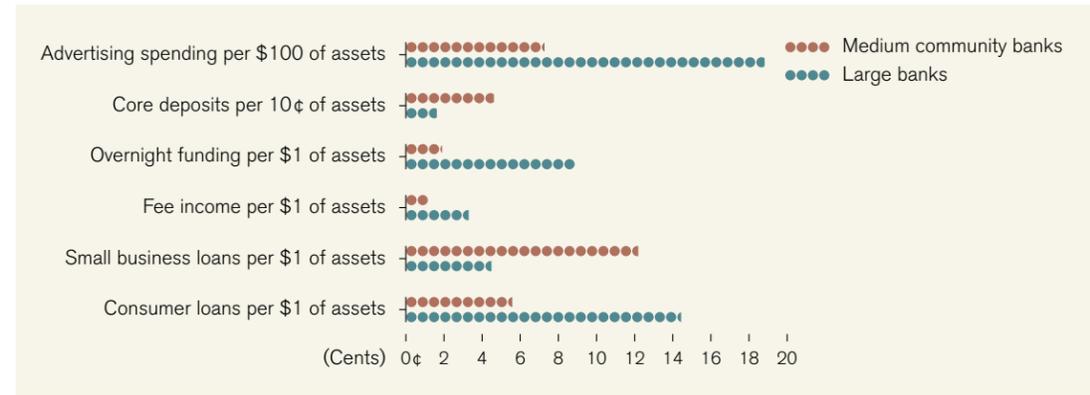
A community bank is a nexus of financial, human, and social capital not easily described in purely quantitative terms. Chiefly important is its local focus. Its owners and its managers have a personal economic stake in the local

common characteristics, their financial needs can differ from each other in subtle ways. A community bank prospers by focusing on the differences of customers within these towns, suburbs, and neighborhoods.

On a dollar-for-dollar basis, community banks make nearly three times as many small business loans as the typical large banking company, and they rely more than twice as much on small deposit accounts for funding. These are long-run economic relationships – community banks do not sell-off the loans they make to local businesses, and they consider their depositors to be permanent customers, not just sources of funds. To make this banking approach work, community bankers invest in a portfolio of local

**Two Very Different Business Models for Large Banks and Medium-Sized Community Banks**

Averages in 2003 for medium-sized community banks (assets between \$100 and \$500 million) and large commercial banks (assets greater than \$10 billion)



economy. Its competitive advantage derives directly from its first-hand knowledge of the people, businesses, and institutions driving the local economy.

To some, the community bank is a manifestation of the Jeffersonian ideal of local economic power, self-employment, and reinvesting local savings in local businesses. In less grand terms, community banks meet the financial needs of local business people, greet their depositors by name, and carry a more-than-fair share of civic responsibilities.

The customers served by community banks typically share a common geography – a suburban town, a rural county, or an urban neighborhood. Because these communities tend to be small in economic terms, so too are the community banks that serve them. But although the households and businesses in these communities share a number of

information – gathered by living in these neighborhoods, frequenting the local businesses, and participating in community events and institutions – and this information allows them to better understand the idiosyncratic financial needs of their customers.

By contrast, large retail banking companies are high-volume operations that focus on the similarities of customers across towns, suburbs, and neighborhoods. Economies of scale allow large banks to efficiently market, produce, and distribute standardized financial services – such as credit cards, securitized home mortgages, retail stock brokerage, and widespread ATM access – to banking customers across multiple towns, cities, and states.

Even after adjusting for bank size, the typical large banking company holds twice as many consumer loans

as community banks – and unlike community banks, it uses these assets to generate fee income (origination fees, servicing fees) rather than interest income, eventually selling off these loans rather than holding them as investments. Compared with community banks, large banks are four times as likely to finance their investments with overnight funds, are more than twice as reliant on fee income, and spend three times more on advertising and marketing.

This mass retail strategy – similar to that used for decades by non-financial consumer product companies – has only recently become accessible to banking companies, due to deregulation and innovations in financial markets and information processing. It is a remarkably efficient approach to providing financial services, but it can grind to a halt if it tries to account for the differences among individual customers.

**A Shrinking Population of Community Banks**

A general rule of thumb defines community banks as those with less than \$1 billion in assets. There are approximately 7,000 such community commercial banks in the U.S. today, and they account for about 95% of the total number of U.S. commercial banks.

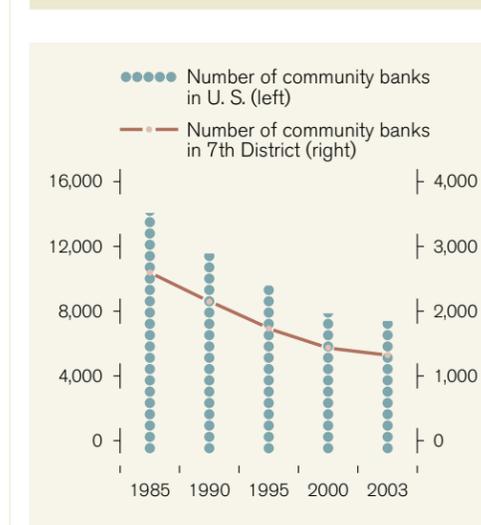
This is a substantial number of banks: approximately one community bank for every 40,000 U.S. citizens, a much higher multiple than in most other western economies. But compared with our recent past, this is a very small number of community banks: The population of U.S. community banks has been cut in half since 1985, when they numbered nearly 14,000. This huge decline would be a small issue if community banks’ market share had held steady, but it has not. The share of U.S. banking assets held by community banks has declined in near lockstep with their dropping numbers, from slightly more than 30% in the mid-1980s to only about 15% today.

Here in the upper Midwest, economic and regulatory conditions have traditionally been very hospitable for community banks. For instance, the Seventh Federal Reserve District (all of Iowa and most of Illinois, Indiana,

Wisconsin and Michigan) is one of 12 Federal Reserve Districts, but it is currently home to about one in every six community banks. But the trend of reduction here has been just as strong – the number of community banks in the Seventh District has fallen from about 2,600 in 1985 to only about 1,300 today.

Why has the number of community banks plummeted? And are these trends likely to continue? More directly, what do these numbers imply for the financial viability of the community bank business model? The most illuminating way to approach these questions, perhaps, is not to ask why so many community banks disappeared in recent years – but rather, why were there so many community banks in the U.S. in the first place?

**A Declining Community Bank Population**



**A Less Hospitable Landscape**

The U.S. is a vast nation, with clusters of economic activity separated by wide geographic spaces. And America has a long history of local political and economic control – as evidenced by the powers held by the 50 state governments to grant local banking charters. In such a world – especially before advances in information and communications technologies allowed financial information to travel instantly across these wide spaces – it is not surprising that

the economic infrastructures in the U.S. would in many ways be local ones, and would feature large numbers of community banks.

Federal and state regulations traditionally protected these local financial institutions from competition. The McFadden Act of 1927 prohibited rival banking companies from crossing state borders to compete with one another, and in many states banks were prohibited from crossing even county borders. The Federal Reserve’s Regulation Q limited the rates that banks could pay to attract depositors, further reducing competition. And the Glass-Steagall Act of 1933 prohibited commercial banks from engaging in the activities of investment banks, securities firms, and insurance companies (and vice versa), further insulating commercial banks from competition.

This was a fabulous world for community bankers. Protected from competition, they could earn strong profits. Or alternatively, they could choose to earn satisfactory profits and simply lead a quiet life.

This environment kept the price of financial services artificially high, reduced banks' incentives to innovate, and bred a population of community bankers largely inexperienced with competitive rivalry. When state and federal regulatory protections were dismantled in the 1980s and 1990s, community banks began to disappear. Aggressive banking companies starved for growth began to move across state borders, and the fastest channel for growth was to acquire existing community banks.

Inefficient and poorly run community banks made especially attractive acquisition candidates. If a community bank could not flourish under the new competitive conditions, it could be purchased for a relatively low price. As an economist would say, these banks had a low opportunity cost for their capital. Consistent with this, about 95% of the nearly 1,500 commercial banks that failed during the 1980s and 1990s have been community banks, further testimony to the inefficiencies bred by years of regulatory protection.

Viewed in this historical context, the recent decline in the number and market share of community banks isn't necessarily a sign that community banks can't be competitive in the future – instead, these changes may simply mark a transformation to a new industry equilibrium. Artificial regulatory barriers had supported an over-populated and inefficient community banking sector, and removing those barriers is allowing the industry to move toward a more 'normal' and efficient structure.

**David and Goliath?**

Is this process of industry consolidation drawing to a close, or is there still a substantial number of community banks left to disappear? How do existing community banks – those that have so far survived the consolidation process – stack up against their larger bank rivals?

In terms of size, community banks are trifling compared with regional, super-regional, and nationwide banking companies. The largest U.S. banking company, the Bank of America, has well over \$1 trillion in assets. Those twelve zeros make it one thousand times larger than the biggest community banks of about \$1 billion! What if we use a less extreme benchmark, say, the typical regional banking company with about \$50 billion in assets? The biggest community banks are still only about one-fiftieth this size.

There is wide agreement among banking economists that community banks' small size puts them at a cost disadvantage relative to their large bank rivals. Scale economies – that is, the reduction in unit costs that a bank captures by growing larger – are difficult to measure exactly for commercial banks. However, there is general agreement that scale economies have a strong cost-reducing effect for small banks and that scale economies continue to generate cost reductions for banks with well in excess of \$1 billion of assets.

Size clearly makes a difference. Large banks can operate with less capital because they are well-diversified, and their large size and high profile gives them access to low-cost sources of equity and debt financing. Large banks can offer a wider set of financial services than community banks – from a full menu of investment and insurance products for households to the risk management tools

and investment banking services demanded by large corporate clients. Large banks can access mass marketing channels to reach households in multiple geographic markets, use in-house research and development to develop proprietary financial products, and reap "convenience dividends" from their widespread systems of branches and ATMs.

But size is not everything. For many community banks, research has shown again and again that the largest source of cost disadvantages is not small scale, but old-fashioned cost inefficiency – this is, most community banks simply use more inputs (labor, branches, deposits) than necessary relative to best-practices community banks. As in any industry, poorly managed, high-cost firms will earn low returns and are unlikely to survive in the long-run.

**Community Banks Have Been Losing Asset Market Share to Large Banks for Two Decades**



Large size can make surprisingly little difference when it comes to using high-tech banking tools. For example, the hardware and software needed to provide Internet banking, electronic bill-pay, check imaging, retail portfolio analysis, and loan scoring are increasingly available to small banks at competitive prices. Moreover, the relationship mentality and non-bureaucratic nature of community banks can in many instances allow them to deploy these tools more quickly and more effectively than large banks.

This brings us to a crucial strategic distinction: By necessity, the decision-makers that run large organizations must operate at a distance from their smaller customers. This distance tends to be reflected in the type of products and quality of service that large banks offer their retail and small business customers – and community banks can be well positioned to exploit this.

**Large Banks: High Volume, Low Cost**

To service tens of thousands of separate retail accounts, large banks rely on automated interfaces rather than in-person contact. On the deposit side, large banks encourage their customers to use the Internet, ATMs, remote call centers, and other electronic channels rather than visiting human tellers at bank branches. On the lending side, large banks use automated credit scoring models to screen applications for credit cards, auto loans, home mortgages, and increasingly for very small business credit lines.

Because these automated processes exhibit substantial scale economies, they provide powerful cost advantages for large banking companies. But the widespread use of these automated processes at large banks has had an additional effect: It has turned traditional banking products into financial commodities.

The commoditization of retail banking has important strategic consequences for large and small banks. For example, mortgage lenders can use credit scoring models

to produce portfolios of loans that are relatively similar in terms, conditions, and credit quality across borrowers. This homogeneity allows banks to re-package large volumes of these loans as asset-backed securities and sell these securities to investors. The financial proceeds can be plowed back into more lending, allowing already large banks to further increase their scale of operations without having to raise more capital.

High-volume securitized lending has reduced the cost of producing loans, expanded households' access to credit, and supported macroeconomic growth by facilitating an historic

number of home mortgage re-financings in recent years. But it has been a mixed blessing for large banking companies. As mortgages, auto loans, and credit cards were turned into financial commodities, lenders lost their pricing power in these lending markets – in effect, a good portion of the cost savings from automated lending processes is offset by lower lending rates in fiercely competitive commoditized markets.

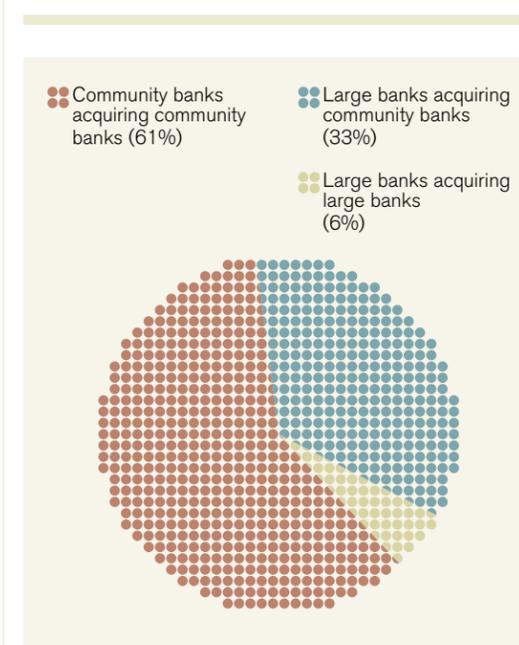
Despite the pressure on profit margins, this approach has proven to be a profitable one for large retail banking companies. The keys to a successful high-volume, low-cost retail banking strategy seem to be continued expansion to achieve

further scale and network economies, strong managerial oversight that holds the line on operating expenses, and establishment of a brand image that helps support prices. Large banks that cannot do these things successfully tend to become acquisition targets for other large banks seeking to grow.

**Community Banks: Low Volume, High Quality**

In contrast to their large bank rivals, community banks are low-volume, high-quality competitors. They eschew mass production and mass marketing, and instead target individual retail and small business customers who need

**Most of the More Than 8,000 Bank Mergers Between 1986 and 2003 Involved at Least One Community Bank**





customized financial products and desire in-person attention – and are willing to pay a premium for these services.

Relationship banking bonds the community bank to its customers. The most celebrated relationship-based product is the small business loan. Locally focused community banks have a clear advantage at assessing the creditworthiness, and monitoring the ongoing condition, of small and medium-sized businesses. These loans are customized to reflect the idiosyncrasies of these borrowers, and cannot be ‘put in a box’ for credit-scoring and securitization.

The low-volume, high-quality strategy is practiced on the deposit side as well. At a well-run community bank, business and household depositors can bank at an ATM, over the telephone, or on the Internet. But unlike large banking companies that offer their customers cash incentives to use these automated banking channels, community banks encourage their deposit customers to visit the bank for personal service.

Community bankers have an almost congenital tendency to make investments in the local community, by funding non-profit institutions and serving on a variety of boards and committees. Although these social investments are in many cases altruistic and generate only non-monetary returns, these activities also tend to reinforce the bonds between community banks and their customers. There is a financial symbiosis between the bank and its community – a sense that one cannot thrive without the success of the other. This contrasts with large banking companies that have an incentive to spend their charitable dollars in big cities where the public relations benefits are larger, and whose managers often rotate through local branches on their way to branches in bigger cities.

Customers are clearly willing to pay a premium for relationship banking. Community banks receive higher interest rates from relationship borrowers, and pay lower interest rates to their core depositors. For example, in 2003 interest rate margins at community banks averaged about 3.8%, substantially larger than the 3.2% margin earned by the typical large banking company. And strong relationships

can lead naturally to the sale of fee-based products – like cash management services to business customers or retirement planning to household customers – without expensive marketing campaigns. If community banks are run well, high interest margins and cross-selling opportunities can offset the cost disadvantages of small size.

There are other indicators that relationship-based banking services are in strong demand in local markets. When a large banking company expands by purchasing a local community bank, it is not unusual for 10 percent (or more) of the purchased bank’s depositors to move their accounts to a competing community bank. And there are hundreds of community bank start-ups in the U.S. each year. More often than not, these brand new banks choose cities and towns where large out-of-state banking companies

have recently acquired local banks.

Large banking companies have recently altered their expansion strategies, entering new markets by opening new branches rather than purchasing existing local banks. This has been especially true in Chicago, where Bank of America, Washington Mutual, Fifth Third and other large banking

companies have opened hundreds of new branches in the past several years. This is a telling change. Expansion via branching has become relatively cheaper in part because the price of acquiring the remaining stock of community banks has increased – a signal that well-run community banking franchises located in attractive local markets have a strong economic future.

**Meeting the Challenges**

While local focus and strong customer relationships give community banks a powerful competitive advantage, it would be premature to conclude that the two-decades-long decline in the community banking sector has ended. Community banks are competing against rivals with increasingly strong competitive advantages of their own: credit unions with tax-advantaged status; large banking

**Community Banks Earn Higher Interest Margins, But Have to Pay Higher Overhead Expenses**



companies with size-based cost and marketing advantages; and specialized non-bank financial institutions – mortgage brokers, stock brokers, financial advisors, insurance agents, finance companies – that can siphon-off community bank customers product-by-product.

Competitive challenges abound. With large credit card banks and consumer finance companies dominating consumer credit markets, community banks have increased their concentrations of real estate loans, a sector in which managing credit risk and interest rate risk has historically been difficult for small banks. As consumer payments continue to evolve away from traditional paper-based checks, community banks must embrace online bill-pay, check imaging, and other new payments technologies, or risk losing some of their highest-valued customers. In direct competition with the securities industry for core household deposits, community banks must further enhance service quality and convenience, or else seek funding from other (perhaps more expensive) sources such as deposit brokers and Federal Home Loan Bank advances. As large banks continue to diversify into securities and insurance activities, community banks will have to forge partnerships with retail brokerages and insurance companies to provide their customers access to a broader array of financial products.

But the first and foremost challenge facing community banks may be a “Goldilocks” problem. If a community bank is too large, it can lose its local focus and hence its special relationships with local businesses and households. But if a community bank is too small, it misses out on potential scale economies, and its cost structure may be too high to remain profitable in a competitive marketplace. To remain financially viable over the long haul, a community bank has to be “just right” in terms of size.

Research performed at the Federal Reserve Bank of Chicago finds that a substantial portion of community banks have performed poorly in recent years. During the late 1990s and early 2000s, the average community bank

generated a lower return-on-equity (ROE) than the average large banking company, and these earnings tended to be unstable as well – high in some years, low in others. Such a pattern of low returns, yet high-return volatility, does not properly compensate bank owners for risk. Were it to persist in the long-run, bank owners would eventually re-allocate their capital to more profitable investments – in other words, their banks would become acquisition targets and would disappear from the industry.

But these studies also find that two broad classes of community banks generate stronger financial returns: larger community banks and well-managed community banks. As

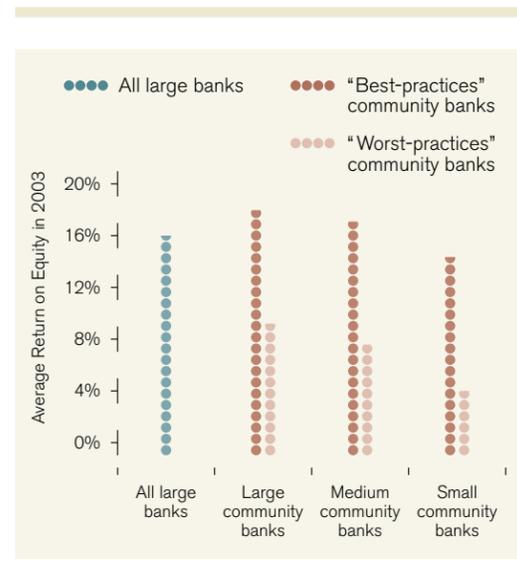
community banks increase in size, they are able to exploit economies of scale that drive down per-unit costs and drive up profitability. Increased size also reduces income volatility. For community banks with at least \$500 million in assets, returns-per-unit-of-risk were comparable to those generated by very large commercial banks.

Management quality appears to make just as big a difference. Dividing the population of community banks into small, medium, and large size classes, and then separating the banks in each of these size classes into high ROE (above median, or “best-practices”) and low ROE (below median,

or “worst-practices”) groups, the studies reveal some striking regularities. Although the smallest community banks face some of the toughest challenges, the data suggest that well-managed community banks of all sizes can generate financial returns quite comparable to those generated by the average large commercial bank.

Apart from these considerations, some community bank investors may be willing to accept a somewhat lower financial return on their investment. Part of their original motive for investing in the community bank was non-pecuniary: They wished to support an institution that would reinforce the financial and social fabric of their community. In addition, these investors often have a large share of their wealth invested in the community bank. Because this is an illiquid

**Community Banks' Profitability Depends on Bank Size and Management Quality**



investment, they want the bank to minimize its risk of failure by holding large amounts of capital, which naturally results in lower returns per dollar invested.

Nonetheless, the implications are clear. While community banks won't need to be nearly so large as their multi-state rivals to be financially viable, it is important for community banks to achieve some modicum of scale economies. And in the increasingly competitive financial marketplace, simply growing larger is not a cure-all: If a community bank is not well-managed, its chance of long-run survival is diminished.

Indeed, the typical community bank has been getting larger. Today the average community bank has around \$150 million in assets, compared with about \$100 million in 1994 and about \$70 million in 1984 (in 2004 dollars). Much of this growth was achieved by taking a page from the playbook of large banking companies and acquiring nearby community banks. Moreover, about one-in-five community banks is affiliated with a multi-community bank holding company organization. This allows these community banks to benefit from additional scale economies like sharing back-office systems and raising capital in public markets, but preserves the advantages of local focus and local decision-making. The median multi-community bank organization holds about \$290 million in assets, and roughly three-out-of-ten hold more than \$500 million in community banking assets.

**A Promising Future for Well-Run Community Banks**

From a purely objective economic viewpoint, whether local markets are served by nationwide banks, regional banks or community banks should make no difference. The structure of the local banking industry will be decided by local consumers and business people, who will reward the banking companies that provide them with the best quality financial services at the lowest prices.

Although predicting the future can be a fool's errand, the following scenario seems likely: Competitive forces will continue to separate the most efficient and progressive banks from the field – large and small banks alike. The best-run community banks will continue to grow larger, while the poorly run will continue to exit the market, with many being acquired by other community banks. As many as one-third to one-half of existing community banks may yet disappear before the banking industry reaches a more stable equilibrium; the remaining community banks will

mostly be larger, and many will operate in more than one town or neighborhood.

But ultimately the exact number of community banks and their collective share of U.S. banking markets are not the most important points. There is a more basic question: Is the locally focused, person-to-person banking approach – that is, community banks at their best – valued in the financial marketplace? The evidence presented in this essay strongly suggests that it is. A substantial portion of community banks are profitable and growing, the market values of these community bank franchises are strong, and new community bank start-ups are typically being well-received in the wake of large bank mergers. Collectively, these observations indicate that many households and small businesses are willing to pay a premium for this approach to banking – an approach that large banking companies find difficult to fully replicate.

Undoubtedly, the future for community banks will continue to be fraught with challenges. But there is abundant evidence that well-run community banks can meet these challenges, and will continue to be a part of the local banking landscape. It appears that there will still be a community bank on Main Street.

*Robert DeYoung is a senior economist and economic advisor in the Research Department at the Federal Reserve Bank of Chicago. DeYoung's current research focuses on the changing structure of domestic and international banking markets and the performance of the financial institutions operating in those markets. His analysis and commentary on these and other issues have appeared in numerous academic journals and industry publications.*

*The information in all charts is from the author's calculations based on Federal Reserve Bank of Chicago data.*

*The views expressed in this essay are the authors' and are not necessarily those of the Federal Reserve Bank of Chicago or the Federal Reserve System.*

BOARD of DIRECTORS FEDERAL RESERVE BANK of CHICAGO



**Chairman**  
**W. James Farrell**  
Chairman and Chief Executive Officer Illinois Tool Works, Inc. Glenview, Illinois



**Deputy Chairman**  
**Miles D. White**  
Chairman and Chief Executive Officer Abbott Laboratories Abbott Park, Illinois



**John A. Canning, Jr.**  
Chairman and CEO Madison Dearborn Partners, Inc. Chicago, Illinois



**Connie E. Evans**  
President and Chief Executive Officer WSEP Ventures Chicago, Illinois



**Mark T. Gaffney**  
President Michigan State AFL-CIO Lansing, Michigan



**James H. Keyes**  
Former Chairman of the Board and Chief Executive Officer Johnson Controls, Inc. Milwaukee, Wisconsin



**Michael L. Kubacki**  
Chairman, President and Chief Executive Officer Lake City Bank and Lakeland Financial Corp. Warsaw, Indiana



**William A. Osborn**  
Chairman and Chief Executive Officer Northern Trust Corp. and Northern Trust Co. Chicago, Illinois



**Alan R. Tubbs**  
President Maquoketa State Bank and Ohnward Bancshares Maquoketa, Iowa



Two directors joined the Chicago Board in 2005: The new directors are Mindy C. Meads, President and Chief Executive Officer, Lands' End, Inc., Dodgeville, Wisconsin, and Jeff Plagge, President and Chief Executive Officer, The First National Bank of Waverly, Waverly, Iowa. Respectively, they replaced James H. Keyes and Alan R. Tubbs, who each completed six years of service.

BOARD of DIRECTORS DETROIT BRANCH



**Chairman**  
**Edsel B. Ford, II**  
Director Ford Motor Company Dearborn, Michigan



**Ralph W. Babb, Jr.**  
Chairman, President and Chief Executive Officer Comerica, Inc. Detroit, Michigan



**Robert E. Churchill**  
Chairman and Chief Executive Officer Citizens National Bank Cheboygan, Michigan



**Roger A. Cregg**  
Executive Vice President Pulte Homes, Inc. Bloomfield Hills, Michigan



**Linda Likely**  
Director of Housing and Community Development Department and Housing Commissions Kalamazoo, Michigan



**Irvin D. Reid**  
President Wayne State University Detroit, Michigan



**Tommi A. White**  
Chief Operating Officer Compuware Corporation Detroit, Michigan



One director joined the Detroit Branch Board in 2005: The new director is Michael M. Magee, Jr., President and Chief Executive Officer of Independent Bank Corporation, Ionia, Michigan. Magee replaces Robert E. Churchill.

## MANAGEMENT COMMITTEE FEDERAL RESERVE BANK of CHICAGO



**Michael H. Moskow**  
President and  
Chief Executive Officer



**Gordon Werkema**  
First Vice President and  
Chief Operating Officer



**Richard P. Anstee\***  
Senior Vice President



**William A. Barouski**  
Senior Vice President  
Customer Relations and  
Support Office (CRSO)



**Barbara D. Benson**  
Senior Vice President  
Strategy, Finance and  
People Practices



**Charles L. Evans**  
Senior Vice President  
and Director of Research



**Glenn C. Hansen**  
Senior Vice President  
Detroit Branch,  
Cash Operations and  
Corporate Communications



**Elizabeth A. Knospe**  
Senior Vice President  
and General Counsel  
Legal Relations, Office  
of the Directors and  
Enterprise Risk  
Management



**Margaret K. Koenigs**  
Vice President  
and General Auditor



**Catharine Lemieux**  
Senior Vice President  
Supervision  
and Regulation



**Angela D. Robinson**  
Senior Vice President  
and EEO Officer  
Technology, Protection,  
Administration, Statistics



**Robert G. Wiley**  
Senior Vice President  
Financial Services  
Group



Senior Vice President of the Financial Services Group Charles W. Furbee (left) retired on March 31, 2004 after 26 years of service.



Senior Vice President of Supervision and Regulation James W. Nelson (center) left the Bank in October 2004 to take a position as Chief Risk Officer at Huntington Bancshares in Columbus, Ohio.



Senior Vice President and Special Advisor to the President Edward J. Green (right) left the Bank in July to assume a teaching position at Pennsylvania State University in State College.

\*Richard P. Anstee retired on December 31, 2004. Although Anstee was in charge of Technology, Finance, Support Services and Corporate Communications for the majority of the year, his responsibilities transferred to other Management Committee members in October in anticipation of his retirement.

As of December 31, 2004

## EXECUTIVE OFFICERS

**Michael H. Moskow**  
President and Chief Executive  
Officer

**Gordon Werkema**  
First Vice President  
and Chief Operating Officer

**Central Bank Activities****Economic Research and Programs**

**Charles L. Evans**  
Senior Vice President and  
Director of Research

**Regional Economic Programs**

**William A. Testa**  
Vice President  
and Economic Advisor

**Banking and Financial Markets**

**Douglas D. Evanoff**  
Vice President  
and Economic Advisor

**Macroeconomic Policy Research**

**David Marshall**  
Vice President  
and Economic Advisor

**Spencer D. Krane**  
Vice President  
and Economic Advisor

**Microeconomic Policy Research**

**Daniel G. Sullivan**  
Vice President  
and Economic Advisor

**Payments Studies**

**Richard D. Porter**  
Vice President

**Thomas G. Ciesielski**  
Vice President

**Consumer and Community Affairs**

**Alicia Williams**  
Vice President

**Supervision and Regulation**

**Catharine Lemieux**  
Senior Vice President

**Operations**

**Douglas J. Kasl**  
Vice President

**Institutions**

**Mark H. Kawa**  
Vice President

**Risk Specialists**

**Richard C. Cahill**  
Vice President

**Services to Depository Institutions****Customer Relations and Support Office (CRSO)**

**William A. Barouski**  
Senior Vice President

**Fedline for the Web**

**Ira R. Zilist**  
Vice President  
and Program Director

**Financial Planning and Controls, Budget, Forecasting, Revenue Management**

**Ellen J. Bromagen**  
Vice President  
and Program Director

**National Marketing and Communications**

**Laura J. Hughes**  
Vice President  
and Program Director

**National Sales**

**Sean Rodriguez**  
Vice President  
and Program Director

**Michael J. Hoppe**  
Vice President  
and Program Manager

**Richard L. Kuxhausen**  
Vice President and Regional  
Sales and Strategy Support

**Financial Services Group**

**Robert G. Wiley**  
Senior Vice President

**Brian Egan**  
Vice President  
(Dedicated to the Retail  
Payments Office)

**District Check Restructuring**

**Deborah A. Schneider**  
Vice President

**Frank S. McKenna**  
Vice President

**Midway Operations**

**Mary H. Sherburne**  
Vice President,  
Midway Site Manager

**Detroit Branch Operations, Cash Operations and Corporate Communications**

**Glenn C. Hansen**  
Senior Vice President

**Cash Operations**  
**Jerome D. Nicolas**  
Vice President

**Corporate Communications**

**G. Douglas Tillett**  
Vice President

**Support Functions****Technology, Protection, Administration, Statistics**

**Angela D. Robinson**  
Senior Vice President  
and EEO Officer

**Technology Group**

**David E. Ritter**  
Vice President

**Administrative Services**

**Kristi L. Zimmermann**  
Vice President

**Statistics**

**Valerie J. Van Meter**  
Vice President

**People Practices, Strategic Planning, Loans and Reserves, Finance and Leadership Development**

**Barbara D. Benson**  
Senior Vice President

**Budget Reporting**

**Jeffrey S. Anderson**  
Vice President

**Accounting, Loans and Reserves**

**Gerard J. Nick**  
Vice President

**Legal Relations & Financial Systems Risk Management**

**Elizabeth A. Knospe**  
Senior Vice President and  
General Counsel

**Yurii Skorin**  
Vice President  
and Associate General Counsel

**Anna M. Voytovich**  
Vice President  
and Associate General Counsel

**Office of the General Auditor**

**Margaret K. Koenigs**  
Vice President  
and General Auditor

**Senior Vice President**

**Richard P. Anstee\***

\*Richard P. Anstee retired on December 31, 2004. Anstee oversaw Technology, Finance, Support Services, and Corporate Communications for the majority of the year. His responsibilities transferred to other Management Committee members in October in anticipation of his retirement.

As of December 31, 2004

## ADVISORY COUNCILS

### Federal Advisory Council Seventh District Representative

**Dennis J. Kuester**  
Marshall & Ilsley Corporation  
Milwaukee, Wisconsin

### Seventh District Advisory Council

**Thomas Kendall Brown**  
Ford Motor Company  
Dearborn, Michigan

**Carl T. Camden**  
Kelly Services, Inc.  
Troy, Michigan

**Richard L. Clarke**  
Healthcare Financial  
Management Association  
Westchester, Illinois

**Erroll B. Davis, Jr.**  
Alliant Energy  
Madison, Wisconsin

**Darcy L. Evon**  
Illinois Institute of Technology  
Chicago, Illinois

**Allan B. Hubbard**  
E&A Industries, Inc.  
Indianapolis, Indiana

**Katherine M. Hudson**  
Brady Corporation  
Milwaukee, Wisconsin

**Christopher P. LaMothe**  
Oxford Financial Group, Ltd.  
Indianapolis, Indiana

**Pamela Forbes Lieberman**  
TruServ Corporation  
Chicago, Illinois

**Bret R. Maxwell**  
MK Capital  
Chicago, Illinois

**Leslie Smith Miller**  
Iowa State Savings Bank  
Knoxville, Iowa

**David Newby**  
Wisconsin State AFL-CIO  
Milwaukee, Wisconsin

**Matthew Paull**  
McDonald's Corporation  
Oak Brook, Illinois

**Robert G. Potter**  
United Food and Commercial  
Workers Local 951  
Grand Rapids, Michigan

**Quintin E. Primo III**  
Capri Capital  
Chicago, Illinois

**James R. Reilly**  
Chicago Convention and  
Tourism Bureau  
Chicago, Illinois

**Donald J. Schneider**  
Schneider National, Inc.  
Green Bay, Wisconsin

**Leland Strom**  
Strom Farm  
Elgin, Illinois

**Jim Theisen**  
Theisen Home Farm Auto  
Dubuque, Iowa

**Jean Wojtowicz**  
Cambridge Capital  
Management Corp.  
Indianapolis, Indiana

### Money Smart Advisory Councils

The Federal Reserve Bank of Chicago and its Detroit Branch coordinate Money Smart Advisory Councils in both Chicago and Detroit. They are made up of representatives of community, financial, government and educational organizations working together to promote financial literacy. Each council sponsors an annual Money Smart Week, which features a variety of activities for consumers that promote financial education. For a list of council members, please visit our Web site at [chicagofed.org](http://chicagofed.org) and go to "Advisory Councils" in the "About the Fed" section.

## EXECUTIVE CHANGES

### Directors

Members of the Federal Reserve Bank of Chicago's boards of directors are selected to represent a cross section of the Seventh District economy, including consumers, industry, agriculture, the service sector, labor and commercial banks of various sizes.

The Chicago board consists of nine members. Member banks elect three bankers and three non-bankers. The Board of Governors appoints three additional non-bankers and designates the Reserve Bank chair and deputy chair from among its three appointees.

The Detroit Branch has a seven-member board of directors. The Board of Governors appoints three non-bankers, and the Chicago Reserve Bank board appoints four additional directors. The Branch board selects its own chair each year, with the approval of the Chicago board. All Reserve Bank and Branch directors serve three-year terms, with a two-term maximum.

### Director appointments and elections at the Chicago Reserve Bank and its Detroit Branch effective in 2004 were:

W. James Farrell re-appointed to a second three-year term as a director through 2006 and designated chairman

Miles D. White designated deputy chairman

John A. Canning, Jr. appointed to complete two years of an unexpired term through 2005

Mark T. Gaffney elected a director through 2006

Michael L. Kubacki elected a director through 2006

Edsel B. Ford II designated Branch chairman

Linda S. Likely appointed as Branch director to complete two years of an unexpired term through 2005

Ralph W. Babb, Jr. appointed as Branch director through 2006

Roger A. Cregg appointed as Branch director through 2006

### At year-end 2004 the following appointments and elections to terms beginning in 2005 were announced:

W. James Farrell re-appointed to a second one-year term as board chairman through 2006

Miles D. White re-appointed to a second three-year term as a director through 2007 and a second one-year term as deputy chairman

Mindy C. Meads elected a director through 2007

Jeff Plagge elected a director through 2007

Michael M. Magee, Jr. appointed a Branch director through 2007

Edsel B. Ford II re-appointed to a second one-year term as Detroit Branch board chairman through 2005

Irvin D. Reid re-appointed to serve a second three-year term as a Branch director through 2007

### Advisory Councils

The Federal Advisory Council, which meets quarterly to discuss business and financial conditions with the Board of Governors in Washington, D.C., is composed of one person from each of the 12 Federal Reserve Districts.

Each year the Chicago Reserve Bank's board of directors selects a representative to this group. Dennis J. Kuester, president and chief executive officer, Marshall & Ilsley Corporation, was selected to be the 2005 representative.

The Seventh District Advisory Council members meet twice a year to provide their views on current business conditions to Chicago Fed President Michael Moskow and other senior officials of the Bank. Input from Council members on regional economic conditions helps contribute to the Federal Reserve System's formulation of national monetary policy.

### Executive Officers

A number of changes were made among the Bank's executive officers during 2004.

### The Bank's board of directors acted on the following vice president and senior vice president promotions during 2004:

Catharine Lemieux to Senior Vice President of Supervision and Regulation

Ellen Bromagen to Vice President, Customer Relations and Support Office

Mark H. Kawa to Vice President, Supervision and Regulation

David A. Marshall to Vice President, Research

### A new vice president appointed by the board in 2004 was:

Richard D. Porter to Vice President, Payments Research

### The following executive officers retired during 2004:

Richard P. Anstee, Senior Vice President, Technology, Finance, Support Services and Corporate Communication retired after 31 years of service.

Charles W. Furbee, Senior Vice President, Financial Services Group, retired after 26 years of service.

James A. Bluemle, Vice President and Division Leader, Supervision and Regulation, retired after 31 years of service.

Thomas G. Ciesielski, Vice President, Economic Research, retired after 34 years of service.

Richard L. Kuxhausen, Vice President, Customer Relations and Support Office, retired after 22 years of service.

Frank S. McKenna, Vice President, Financial Services Group, retired after 34 years of service.

## OPERATIONS VOLUMES

	Dollar Amount		Number of Items	
	2004	2003	2004	2003
<b>Check and Electronic Payments</b>				
Checks, NOWs and Share Drafts Processed	1.7 Trillion	1.7 Trillion	2.0 Billion	2.3 Billion
Fine Sort and Packaged Checks Handled	10.3 Billion	10.5 Billion	15.1 Million	16.2 Million
Images Captured	—	—	92.3 Million	72.9 Million
<b>Cash Operations</b>				
Currency Received and Counted	53.2 Billion	52.5 Billion	3.7 Billion	3.4 Billion
Unfit Currency Destroyed	6.5 Billion	7.1 Billion	602.3 Million	615.4 Million
Coin Bags Paid and Received	1.7 Billion	1.6 Billion	4.0 Million	3.8 Million
Number of Notes Paid and Received	122.1 Billion	122.2 Billion	8.5 Billion	8.4 Billion
<b>Loans to Depository Institutions</b>				
Total Loans Made During Year	1.5 Billion	4.8 Billion	1.3 Thousand	0.6 Thousand

## AUDITOR INDEPENDENCE

The firm engaged by the Board of Governors for the audits of the individual and combined financial statements of the Reserve Banks for 2004 was PricewaterhouseCoopers LLP (PwC). Fees for these services totaled \$2.0 million. To ensure auditor independence, the Board of Governors requires that PwC be independent in all matters relating to the audit. Specifically, PwC may not perform services for the Reserve Banks or others that would place it in a position of auditing its own work, making management decisions on behalf of the Reserve Banks, or in any other way impairing its audit independence. In 2004, the Bank did not engage PwC for any material advisory services.

## 2004 FINANCIAL REPORTS

### Management Assertion

March 2005

#### To the Board of Directors of the Federal Reserve Bank of Chicago

The management of the Federal Reserve Bank of Chicago ("FRBC") is responsible for the preparation and fair presentation of the Statement of Financial Condition, Statement of Income, and Statement of Changes in Capital as of December 31, 2004 (the "Financial Statements"). The Financial Statements have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System and as set forth in the Financial Accounting Manual for the Federal Reserve Banks ("Manual"), and as such, include amounts, some of which are based on judgments and estimates of management. To our knowledge, the Financial Statements are, in all material respects, fairly presented in conformity with the accounting principles, policies and practices documented in the Manual and include all disclosures necessary for such fair presentation.

The management of the FRBC is responsible for maintaining an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements. Such internal controls are designed to provide reasonable assurance to management and to the Board of Directors regarding the preparation of reliable Financial Statements. This process of internal controls contains self-monitoring mechanisms, including, but not limited to, divisions of responsibility and a code of conduct. Once identified, any material deficiencies in the process of internal controls are reported to management, and appropriate corrective measures are implemented.

Even an effective process of internal controls, no matter how well designed, has inherent limitations, including the possibility of human error, and therefore can provide only reasonable assurance with respect to the preparation of reliable financial statements.

The management of the FRBC assessed its process of internal controls over financial reporting including the safeguarding of assets reflected in the Financial Statements, based upon the criteria established in the "Internal Control — Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, we believe that the FRBC maintained an effective process of internal controls over financial reporting including the safeguarding of assets as they relate to the Financial Statements.

#### Federal Reserve Bank of Chicago

Michael Moskow  
President

Gordon Werkema  
First Vice President

Barbara Benson  
Senior Vice President



#### PricewaterhouseCoopers LLP

One North Wacker  
Chicago, IL 60606  
Telephone (312) 298-2000  
Facsimile (312) 298-2001

### Report of Independent Accountants

#### To the Board of Directors of The Federal Reserve Bank of Chicago

We have examined management's assertion, included in the accompanying Management Assertion, that the Federal Reserve Bank of Chicago ("FRBC") maintained effective internal control over financial reporting and the safeguarding of assets as they relate to the financial statements as of December 31, 2004, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. FRBC's management is responsible for maintaining effective internal control over financial reporting and safeguarding of assets as they relate to the financial statements. Our responsibility is to express an opinion on management's assertion based on our examination.

Our examination was conducted in accordance with attestation standards established by the American Institute of Certified Public Accountants and, accordingly, included obtaining an understanding of internal control over financial reporting, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

Because of inherent limitations in any internal control, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of internal control over financial reporting to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assertion that FRBC maintained effective internal control over financial reporting and over the safeguarding of assets as they relate to the financial statements as of December 31, 2004 is fairly stated, in all material respects, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

This report is intended solely for the information and use of management and the Board of Directors and Audit Committee of FRBC, and any organization with legally defined oversight responsibilities and is not intended to be and should not be used by anyone other than these specified parties.

March 16, 2005



**PricewaterhouseCoopers LLP**  
 One North Wacker  
 Chicago, IL 60606  
 Telephone (312) 298-2000  
 Facsimile (312) 298-2001

### Report of Independent Auditors

#### To the Board of Governors of The Federal Reserve System and the Board of Directors of The Federal Reserve Bank of Chicago

We have audited the accompanying statements of condition of the Federal Reserve Bank of Chicago (the "Bank") as of December 31, 2004 and 2003, and the related statements of income and changes in capital for the years then ended, which have been prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 3, these financial statements were prepared in conformity with the accounting principles, policies, and practices established by the Board of Governors of the Federal Reserve System. These principles, policies, and practices, which were designed to meet the specialized accounting and reporting needs of the Federal Reserve System, are set forth in the Financial Accounting Manual for Federal Reserve Banks and constitute a comprehensive basis of accounting other than accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2004 and 2003, and results of its operations for the years then ended, on the basis of accounting described in Note 3.

March 16, 2005

## 2004 FINANCIAL STATEMENTS

Statements of Condition, in Millions.	As of December 31,	2004	2003
<b>Assets</b>			
Gold certificates		\$ 924	\$ 982
Special drawing rights certificates		212	212
Coin		111	90
Items in process of collection		559	942
Loans to depository institutions		14	17
U.S. government securities, net		65,359	68,267
Investments denominated in foreign currencies		2,232	2,033
Accrued interest receivable		458	510
Interdistrict settlement account		225	–
Bank premises and equipment, net		186	157
Other assets		40	40
<b>Total Assets</b>		<b>\$ 70,320</b>	<b>\$ 73,250</b>
<b>Liabilities and Capital</b>			
<b>Liabilities:</b>			
Federal Reserve notes outstanding, net		\$ 63,471	\$ 58,694
Securities sold under agreements to repurchase		2,773	2,592
<b>Deposits:</b>			
Depository institutions		1,762	2,350
Other deposits		4	4
Deferred credit items		421	781
Interest on Federal Reserve notes due U.S. Treasury		244	29
Interdistrict settlement account		–	6,831
Accrued benefit costs		83	93
Other liabilities		36	28
<b>Total Liabilities</b>		<b>68,794</b>	<b>71,402</b>
<b>Capital:</b>			
Capital paid-in		763	924
Surplus		763	924
<b>Total Capital</b>		<b>1,526</b>	<b>1,848</b>
<b>Total Liabilities and Capital</b>		<b>\$ 70,320</b>	<b>\$ 73,250</b>

The accompanying notes are an integral part of these financial statements.

Statements of Income, in Millions.	For the years ended December 31,	2004	2003
<b>Interest Income</b>			
Interest on U.S. government securities		\$ 2,041	\$ 2,358
Interest on investments denominated in foreign currencies		28	27
Interest on loans to depository institutions		1	-
<b>Total Interest Income</b>		<b>2,070</b>	<b>2,385</b>
<b>Interest Expense</b>			
Interest expense on securities sold under agreements to repurchase		28	23
<b>Net Interest Income</b>		<b>2,042</b>	<b>2,362</b>
<b>Other Operating Income</b>			
Income from services		114	108
Reimbursable services to government agencies		7	6
Foreign currency gains, net		129	276
Other income		7	8
<b>Total Other Operating Income</b>		<b>257</b>	<b>398</b>
<b>Operating Expenses</b>			
Salaries and other benefits		143	169
Occupancy expense		21	22
Equipment expense		16	19
Assessments by Board of Governors		76	75
Other expenses		83	65
<b>Total Operating Expenses</b>		<b>339</b>	<b>350</b>
<b>Net Income Prior to Distribution</b>		<b>\$ 1,960</b>	<b>\$ 2,410</b>
<b>Distribution of Net Income</b>			
Dividends paid to member banks		\$ 57	\$ 53
Transferred (from)/to surplus		(161)	67
Payments to U.S. Treasury as interest on Federal Reserve notes		2,064	2,290
<b>Total Distribution</b>		<b>\$ 1,960</b>	<b>\$ 2,410</b>

The accompanying notes are an integral part of these financial statements.

Statements of Changes in Capital, in Millions.			
For the years ended December 31, 2004 and December 31, 2003	Capital Paid-in	Surplus	Total Capital
<b>Balance at January 1, 2003 (17.2 million shares)</b>	\$ 857	\$ 857	\$ 1,714
Transferred to surplus	-	67	67
Net change in capital stock issued (1.3 million shares)	67	-	67
<b>Balance at December 31, 2003 (18.5 million shares)</b>	\$ 924	\$ 924	\$ 1,848
Transferred (from) surplus	-	(161)	(161)
Net change in capital stock redeemed (3.2 million shares)	(161)	-	(161)
<b>Balance at December 31, 2004 (15.3 million shares)</b>	\$ 763	\$ 763	\$ 1,526

The accompanying notes are an integral part of these financial statements.

## NOTES TO FINANCIAL STATEMENTS

### 1. Structure

The Federal Reserve Bank of Chicago ("Bank") is part of the Federal Reserve System ("System") created by Congress under the Federal Reserve Act of 1913 ("Federal Reserve Act") which established the central bank of the United States. The System consists of the Board of Governors of the Federal Reserve System ("Board of Governors") and twelve Federal Reserve Banks ("Reserve Banks"). The Reserve Banks are chartered by the federal government and possess a unique set of governmental, corporate, and central bank characteristics. The Bank and its branch in Detroit, Michigan, serve the Seventh Federal Reserve District, which includes Iowa and portions of Michigan, Illinois, Wisconsin and Indiana. Other major elements of the System are the Federal Open Market Committee ("FOMC") and the Federal Advisory Council. The FOMC is composed of members of the Board of Governors, the president of the Federal Reserve Bank of New York ("FRBNY") and, on a rotating basis, four other Reserve Bank presidents. Banks that are members of the System include all national banks and any state-chartered bank that applies and is approved for membership in the System.

### Board of Directors

In accordance with the Federal Reserve Act, supervision and control of the Bank is exercised by a Board of Directors. The Federal Reserve Act specifies the composition of the Board of Directors for each of the Reserve Banks. Each board is composed of nine members serving three-year terms: three directors, including those designated as Chairman and Deputy Chairman, are appointed by the Board of Governors, and six directors are elected by member banks. Of the six elected by member banks, three represent the public and three represent member banks. Member banks are divided into three classes according to size. Member banks in each class elect one director representing member banks and one

representing the public. In any election of directors, each member bank receives one vote, regardless of the number of shares of Reserve Bank stock it holds.

### 2. Operations and Services

The System performs a variety of services and operations. Functions include: formulating and conducting monetary policy; participating actively in the payments mechanism, including large-dollar transfers of funds, automated clearinghouse ("ACH") operations and check processing; distributing coin and currency; performing fiscal agency functions for the U.S. Treasury and certain federal agencies; serving as the federal government's bank; providing short-term loans to depository institutions; serving the consumer and the community by providing educational materials and information regarding consumer laws; supervising bank holding companies and state member banks; and administering other regulations of the Board of Governors. The Board of Governors' operating costs are funded through assessments on the Reserve Banks.

The FOMC establishes policy regarding open market operations, oversees these operations, and issues authorizations and directives to the FRBNY for its execution of transactions. Authorized transaction types include direct purchase and sale of securities, the purchase of securities under agreements to resell, the sale of securities under agreements to repurchase, and the lending of U.S. government securities. The FRBNY is also authorized by the FOMC to hold balances of, and to execute spot and forward foreign exchange ("F/X") and securities contracts in, nine foreign currencies and to invest such foreign currency holdings ensuring adequate liquidity is maintained. In addition, FRBNY is authorized to maintain reciprocal currency arrangements ("F/X swaps") with various central banks, and "warehouse" foreign currencies for the U.S. Treasury and Exchange

Stabilization Fund ("ESF") through the Reserve Banks.

### 3. Significant Accounting Policies

Accounting principles for entities with the unique powers and responsibilities of the nation's central bank have not been formulated by the Financial Accounting Standards Board. The Board of Governors has developed specialized accounting principles and practices that it believes are appropriate for the significantly different nature and function of a central bank as compared with the private sector. These accounting principles and practices are documented in the *Financial Accounting Manual for Federal Reserve Banks* ("Financial Accounting Manual"), which is issued by the Board of Governors. All Reserve Banks are required to adopt and apply accounting policies and practices that are consistent with the Financial Accounting Manual.

The financial statements have been prepared in accordance with the Financial Accounting Manual. Differences exist between the accounting principles and practices of the System and accounting principles generally accepted in the United States of America ("GAAP"). The primary difference is the presentation of all security holdings at amortized cost, rather than at the fair value presentation requirements of GAAP. In addition, the Bank has elected not to present a Statement of Cash Flows. The Statement of Cash Flows has not been included because the liquidity and cash position of the Bank are not of primary concern to the users of these financial statements. Other information regarding the Bank's activities is provided in, or may be derived from, the Statements of Condition, Income, and Changes in Capital. A Statement of Cash Flows, therefore, would not provide any additional useful information. There are no other significant differences between the policies outlined in the Financial Accounting Manual and GAAP.

Each Reserve Bank provides services on behalf of the System for which

costs are not shared. Major services provided on behalf of the System by the Bank, for which the costs were not redistributed to the other Reserve Banks, include national business development and customer support.

The preparation of the financial statements in conformity with the Financial Accounting Manual requires management to make certain estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of income and expenses during the reporting period. Actual results could differ from those estimates. Certain amounts relating to the prior year have been reclassified to conform to the current-year presentation. Unique accounts and significant accounting policies are explained below.

### A. Gold Certificates

The Secretary of the Treasury is authorized to issue gold certificates to the Reserve Banks to monetize gold held by the U.S. Treasury. Payment for the gold certificates by the Reserve Banks is made by crediting equivalent amounts in dollars into the account established for the U.S. Treasury. These gold certificates held by the Reserve Banks are required to be backed by the gold of the U.S. Treasury. The U.S. Treasury may reacquire the gold certificates at any time and the Reserve Banks must deliver them to the U.S. Treasury. At such time, the U.S. Treasury's account is charged and the Reserve Banks' gold certificate accounts are lowered. The value of gold for purposes of backing the gold certificates is set by law at \$42 2/9 a fine troy ounce. The Board of Governors allocates the gold certificates among Reserve Banks once a year based on average Federal Reserve notes outstanding in each District.

### B. Special Drawing Rights Certificates

Special drawing rights ("SDRs") are issued by the International Monetary Fund ("Fund") to its members in proportion to each member's quota

in the Fund at the time of issuance. SDRs serve as a supplement to international monetary reserves and may be transferred from one national monetary authority to another. Under the law providing for United States participation in the SDR system, the Secretary of the U.S. Treasury is authorized to issue SDR certificates, somewhat like gold certificates, to the Reserve Banks. At such time, equivalent amounts in dollars are credited to the account established for the U.S. Treasury, and the Reserve Banks' SDR certificate accounts are increased. The Reserve Banks are required to purchase SDR certificates, at the direction of the U.S. Treasury, for the purpose of financing SDR acquisitions or for financing exchange stabilization operations. At the time SDR transactions occur, the Board of Governors allocates SDR certificate transactions among Reserve Banks based upon Federal Reserve notes outstanding in each District at the end of the preceding year. There were no SDR transactions in 2004 or 2003.

### C. Loans to Depository Institutions

The Depository Institutions Deregulation and Monetary Control Act of 1980 provides that all depository institutions that maintain reservable transaction accounts or nonpersonal time deposits, as defined in Regulation D issued by the Board of Governors, have borrowing privileges at the discretion of the Reserve Banks. Borrowers execute certain lending agreements and deposit sufficient collateral before credit is extended. Loans are evaluated for collectibility, and currently all are considered collectible and fully collateralized. If any loans were deemed to be uncollectible, an appropriate reserve would be established. Interest is accrued using the applicable discount rate established at least every fourteen days by the Board of Directors of the Reserve Banks, subject to review by the Board of Governors.

### D. U.S. Government and Federal Agency Securities and Investments Denominated in Foreign Currencies

The FOMC has designated the FRBNY to execute open market transactions

on its behalf and to hold the resulting securities in the portfolio known as the System Open Market Account ("SOMA"). In addition to authorizing and directing operations in the domestic securities market, the FOMC authorizes and directs the FRBNY to execute operations in foreign markets for major currencies in order to counter disorderly conditions in exchange markets or to meet other needs specified by the FOMC in carrying out the System's central bank responsibilities. Such authorizations are reviewed and approved annually by the FOMC.

The FRBNY has sole authorization by the FOMC to lend U.S. government securities held in the SOMA to U.S. government securities dealers and to banks participating in U.S. government securities clearing arrangements on behalf of the System, in order to facilitate the effective functioning of the domestic securities market. These securities-lending transactions are fully collateralized by other U.S. government securities. FOMC policy requires the FRBNY to take possession of collateral in excess of the market values of the securities loaned. The market values of the collateral and the securities loaned are monitored by the FRBNY on a daily basis, with additional collateral obtained as necessary. The securities loaned continue to be accounted for in the SOMA.

F/X contracts are contractual agreements between two parties to exchange specified currencies, at a specified price, on a specified date. Spot foreign contracts normally settle two days after the trade date, whereas the settlement date on forward contracts is negotiated between the contracting parties, but will extend beyond two days from the trade date. The FRBNY generally enters into spot contracts, with any forward contracts generally limited to the second leg of a swap/warehousing transaction.

The FRBNY, on behalf of the Reserve Banks, maintains renewable, short-term F/X swap arrangements with two authorized foreign central banks. The parties agree to exchange their currencies up to a pre-arranged maximum amount and for an agreed

upon period of time (up to twelve months), at an agreed upon interest rate. These arrangements give the FOMC temporary access to foreign currencies it may need for intervention operations to support the dollar and give the partner foreign central bank temporary access to dollars it may need to support its own currency. Drawings under the F/X swap arrangements can be initiated by either the FRBNY or the partner foreign central bank and must be agreed to by the drawee. The F/X swaps are structured so that the party initiating the transaction (the drawer) bears the exchange rate risk upon maturity. The FRBNY will generally invest the foreign currency received under an F/X swap in interest-bearing instruments.

Warehousing is an arrangement under which the FOMC agrees to exchange, at the request of the Treasury, U.S. dollars for foreign currencies held by the Treasury or ESF over a limited period of time. The purpose of the warehousing facility is to supplement the U.S. dollar resources of the Treasury and ESF for financing purchases of foreign currencies and related international operations.

In connection with its foreign currency activities, the FRBNY, on behalf of the Reserve Banks, may enter into contracts that contain varying degrees of off-balance sheet market risk, because they represent contractual commitments involving future settlement and counter-party credit risk. The FRBNY controls credit risk by obtaining credit approvals, establishing transaction limits, and performing daily monitoring procedures.

While the application of current market prices to the securities currently held in the SOMA portfolio and investments denominated in foreign currencies may result in values substantially above or below their carrying values, these unrealized changes in value would have no direct effect on the quantity of reserves available to the banking system or on the prospects for future Reserve Bank earnings or capital. Both the domestic and foreign

components of the SOMA portfolio from time to time involve transactions that can result in gains or losses when holdings are sold prior to maturity. Decisions regarding the securities and foreign currencies transactions, including their purchase and sale, are motivated by monetary policy objectives rather than profit. Accordingly, market values, earnings and any gains or losses resulting from the sale of such currencies and securities are incidental to the open market operations and do not motivate its activities or policy decisions.

U.S. government securities and investments denominated in foreign currencies comprising the SOMA are recorded at cost, on a settlement-date basis, and adjusted for amortization of premiums or accretion of discounts on a straight-line basis. Securities sold under agreements to repurchase are treated as secured borrowing transactions with the associated interest expense recognized over the life of the transaction. Such transactions are settled by FRBNY. Interest income is accrued on a straight-line basis. Income earned on securities lending transactions is reported as a component of "Other income." Gains and losses resulting from sales of securities are determined by specific issues based on average cost. Foreign-currency-denominated assets are revalued daily at current foreign currency market exchange rates in order to report these assets in U.S. dollars. Realized and unrealized gains and losses on investments denominated in foreign currencies are reported as "Foreign currency gains, net."

Activity related to U.S. government securities bought outright, securities sold under agreements to repurchase, securities loaned, investments denominated in foreign currency, excluding those held under an F/X swap arrangement, and deposit accounts of foreign central banks and governments above core balances are allocated to each Reserve Bank. U.S. government securities purchased under agreements to resell and unrealized gains and losses on the revaluation of foreign currency holdings under

F/X swaps and warehousing arrangements are allocated to the FRBNY and not to other Reserve Banks.

In 2003, additional interest income of \$61 million, representing one day's interest on the SOMA portfolio, was accrued to reflect a change in interest accrual methods, of which \$6.2 million was allocated to the Bank. The effect of this change was not material; therefore, it was included in the 2003 interest income.

#### E. Bank Premises, Equipment and Software

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is calculated on a straight-line basis over estimated useful lives of assets ranging from two to fifty years. Major alterations, renovations and improvements are capitalized at cost as additions to the asset accounts and are amortized over the remaining useful life of the asset. Maintenance, repairs and minor replacements are charged to operations in the year incurred. Costs incurred for software, either developed internally or acquired for internal use, during the application development stage are capitalized based on the cost of direct services and materials associated with designing, coding, installing, or testing software. Capitalized software costs are amortized on a straight-line basis over the estimated useful lives of the software applications, which range from two to five years.

#### F. Interdistrict Settlement Account

At the close of business each day, all Reserve Banks and branches assemble the payments due to or from other Reserve Banks and branches as a result of transactions involving accounts residing in other Districts that occurred during the day's operations. Such transactions may include funds settlement, check clearing and ACH operations, and allocations of shared expenses. The cumulative net amount due to or from other Reserve Banks is reported as the "Interdistrict settlement account."

#### G. Federal Reserve Notes

Federal Reserve notes are the circulating currency of the United States. These notes are issued through the various Federal Reserve agents (the Chairman of the Board of Directors of each Reserve Bank) to the Reserve Banks upon deposit with such agents of certain classes of collateral security, typically U.S. government securities. These notes are identified as issued to a specific Reserve Bank. The Federal Reserve Act provides that the collateral security tendered by the Reserve Bank to the Federal Reserve agent must be equal to the sum of the notes applied for by such Reserve Bank.

Assets eligible to be pledged as collateral security include all Federal Reserve Bank assets. The collateral value is equal to the book value of the collateral tendered, with the exception of securities, whose collateral value is equal to the par value of the securities tendered. The par value of securities pledged for securities sold under agreements to repurchase is similarly deducted.

The Board of Governors may, at any time, call upon a Reserve Bank for additional security to adequately collateralize the Federal Reserve notes. To satisfy the obligation to provide sufficient collateral for outstanding Federal Reserve notes, the Reserve Banks have entered into an agreement that provides for certain assets of the Reserve Banks to be jointly pledged as collateral for the Federal Reserve notes of all Reserve Banks. In the event that this collateral is insufficient, the Federal Reserve Act provides that Federal Reserve notes become a first and paramount lien on all the assets of the Reserve Banks. Finally, as obligations of the United States, Federal Reserve notes are backed by the full faith and credit of the United States government.

The "Federal Reserve notes outstanding, net" account represents the Bank's Federal Reserve notes outstanding, reduced by its currency holdings of \$9,046 million, and \$8,141 million at December 31, 2004 and 2003, respectively.

#### H. Capital Paid-in

The Federal Reserve Act requires that each member bank subscribe to the capital stock of the Reserve Bank in an amount equal to 6 percent of the capital and surplus of the member bank. As a member bank's capital and surplus changes, its holdings of the Reserve Bank stock must be adjusted. Member banks are those state-chartered banks that apply and are approved for membership in the System and all national banks. Currently, only one-half of the subscription is paid-in and the remainder is subject to call. These shares are nonvoting with a par value of \$100. They may not be transferred or hypothecated. By law, each member bank is entitled to receive an annual dividend of 6 percent on the paid-in capital stock. This cumulative dividend is paid semiannually. A member bank is liable for Reserve Bank liabilities up to twice the par value of stock subscribed by it.

The Financial Accounting Standards Board (FASB) has deferred the implementation date for SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity" for the Bank. When applicable, the Bank will determine the impact and provide the appropriate disclosures.

#### I. Surplus

The Board of Governors requires Reserve Banks to maintain a surplus equal to the amount of capital paid-in as of December 31. This amount is intended to provide additional capital and reduce the possibility that the Reserve Banks would be required to call on member banks for additional capital.

Pursuant to Section 16 of the Federal Reserve Act, Reserve Banks are required by the Board of Governors to transfer to the U.S. Treasury as interest on Federal Reserve notes excess earnings, after providing for the costs of operations, payment of dividends, and reservation of an amount necessary to equate surplus with capital paid-in.

In the event of losses or an increase in capital paid-in, payments to the U.S. Treasury are suspended and earnings are retained until the surplus is equal to the capital paid-in. Weekly payments to the U.S. Treasury may vary significantly.

In the event of a decrease in capital paid-in, the excess surplus, after equating capital paid-in and surplus at December 31, is distributed to the U.S. Treasury in the following year. This amount is reported as a component of "Payments to U.S. Treasury as interest on Federal Reserve notes".

#### J. Income and Costs related to Treasury Services

The Bank is required by the Federal Reserve Act to serve as fiscal agent and depository of the United States. By statute, the Department of the Treasury is permitted, but not required, to pay for these services.

#### K. Taxes

The Reserve Banks are exempt from federal, state, and local taxes, except for taxes on real property. The Bank's real property taxes were \$2 million and \$4 million for the years ended December 31, 2004 and 2003, respectively, and are reported as a component of "Occupancy expense."

#### L. 2004 Restructuring Charges

In 2003, the System started the restructuring of several operations, primarily check, cash and Treasury services. The restructuring included streamlining the management and support structures, reducing staff, decreasing the number of processing locations, and increasing processing capacity in the remaining locations. These restructuring activities continued in 2004.

Footnote 10 describes the restructuring and provides information about the Bank's costs and liabilities associated with employee separations and contract terminations. The costs associated with the write-down of certain Bank assets are discussed in footnote 6. Costs and

liabilities associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY.

#### 4. U.S. Government and Federal Agency Securities

Securities bought outright are held in the SOMA at the FRBNY. An undivided interest in SOMA activity and the related premiums, discounts and income, with the exception of securities purchased under agreements to resell, is allocated to each Reserve Bank on a percentage basis derived from an annual settlement of interdistrict clearings that occurs in April of each year. The settlement equalizes Reserve Bank gold certificate holdings to Federal Reserve notes outstanding. The Bank's allocated share of SOMA balances was approximately 9.008 percent and 10.105 percent at December 31, 2004 and 2003, respectively.

The Bank's allocated share of U.S. Government securities, net held in the SOMA at December 31, was as follows (in millions):

	2004	2003
Par value:		
U.S. government:		
Bills	\$ 23,688	\$ 24,740
Notes	32,503	32,676
Bonds	8,469	9,951
Total par value	\$ 64,660	\$ 67,367
Unamortized premiums	847	990
Unaccrued discounts	(148)	(90)
Total allocated to Bank	\$ 65,359	\$ 68,267

The total of SOMA securities bought outright was \$725,584 million and \$675,569 million at December 31, 2004 and 2003, respectively.

The maturity distribution of U.S. government securities bought outright and securities sold under agreements to repurchase, that were allocated to the Bank at December 31, 2004, was as follows (in millions):

Maturities of Securities Held	U.S. Gov't Securities (Par value)	Securities Sold Under Agreements to Repurchase (Contract amount)
Within 15 days	\$ 2,761	\$ 2,773
16 days to 90 days	16,066	—
91 days to 1 year	15,350	—
Over 1 year to 5 years	18,760	—
Over 5 years to 10 years	4,898	—
Over 10 years	6,825	—
Total	\$ 64,660	\$ 2,773

At December 31, 2004, U.S. government securities with a par value of \$6,609 million were loaned from the SOMA, of which \$595 million was allocated to the Bank.

At December 31, 2004, securities sold under agreements to repurchase with a contract amount of \$30,783 million and a par value of \$30,808 million were outstanding. The Bank's allocated share at December 31, 2004 was \$2,773 million of the contract amount and \$2,775 million of the par value.

#### 5. Investments Denominated in Foreign Currencies

The FRBNY, on behalf of the Reserve Banks, holds foreign currency deposits with foreign central banks and the Bank for International Settlements and invests in foreign government debt instruments. Foreign government debt instruments held include both securities bought outright and securities purchased under agreements to resell. These investments are guaranteed as to principal and interest by the foreign governments.

Each Reserve Bank is allocated a share of foreign-currency-denominated assets, the related interest income, and realized and unrealized foreign currency gains and losses, with the exception of unrealized gains and losses on F/X swaps and warehousing transactions. This allocation is based on the ratio of each Reserve Bank's capital and

surplus to aggregate capital and surplus at the preceding December 31. The Bank's allocated share of investments denominated in foreign currencies was approximately 10.447 percent and 10.234 percent at December 31, 2004 and 2003, respectively.

The Bank's allocated share of investments denominated in foreign currencies, valued at current foreign currency market exchange rates at December 31, was as follows (in millions):

	2004	2003
<i>European Union Euro:</i>		
Foreign currency deposits	\$ 633	\$ 703
Securities purchased under agreements to resell	224	211
Government debt instruments	401	208
<i>Japanese Yen:</i>		
Foreign currency deposits	161	151
Government debt instruments	800	751
Accrued interest	13	9
Total	\$ 2,232	\$ 2,033

Total System investments denominated in foreign currencies were \$21,368 million and \$19,868 million at December 31, 2004 and 2003, respectively.

The maturity distribution of investments denominated in foreign currencies which were allocated to the Bank at December 31, 2004, was as follows (in millions):

Maturities of Investments Denominated in Foreign Currencies	European Euro	Japanese Yen	Total
Within 1 year	\$ 938	\$ 961	\$ 1,899
Over 1 year to 5 years	314	—	314
Over 5 years to 10 years	19	—	19
Over 10 years	—	—	—
Total	\$ 1,271	\$ 961	\$ 2,232

At December 31, 2004 and 2003, there were no material open foreign exchange contracts.

At December 31, 2004 and 2003, the warehousing facility was \$5,000 million, with no balance outstanding.

#### 6. Bank Premises, Equipment and Software

A summary of bank premises and equipment at December 31 is as follows (in millions):

	Maximum Useful Life (in years)	2004	2003
Bank premises and equipment:			
Land	N/A	\$ 9	\$ 10
Buildings	50	153	140
Building machinery and equipment	20	22	22
Construction in progress	N/A	41	15
Furniture and equipment	10	66	94
Subtotal		\$ 291	\$ 281
Accumulated depreciation		(105)	(124)
Bank premises and equipment, net		\$ 186	\$ 157
Depreciation expense, for the years ended		\$ 14	\$ 15

Bank premises and equipment at December 31 include the following amounts for leases that have been capitalized (in millions):

	2004	2003
Bank premises and equipment	\$ 0.6	\$ 0.6
Accumulated depreciation	(0.3)	(0.2)
Capitalized leases, net	\$ 0.3	\$ 0.4

The Bank leases unused space to outside tenants. Those leases have terms ranging from one to eight

years. Rental income from such leases was \$3 million for each of the years ended December 31, 2004 and 2003. Future minimum lease payments under noncancelable agreements in existence at December 31, 2004, were (in millions):

2005	\$ 3
2006	3
2007	1
2008	1
2009	1
Thereafter	—
	\$ 9

The Bank has capitalized software assets, net of amortization, of \$14 million and \$10 million at December 31, 2004 and 2003, respectively. Amortization expense was \$1 million and \$2 million for each of the years ended December 31, 2004 and 2003, respectively.

Assets impaired as a result of the Bank's restructuring plan as discussed in footnote 10 include software, building, furniture, and equipment. Asset impairment losses of \$0.5 million and \$0.4 million for the periods ending December 31, 2004 and 2003, respectively were determined using fair values based on quoted market values or other valuation techniques and are reported as a component of "Other expenses."

The Bank recognized an impairment loss on the Detroit facility of \$1.4 million for the period ended December 31, 2004 due to its determination that the carry value exceeded the fair value of the property. The impairment was determined using fair values based on quoted market values or other valuation techniques and is reported as a component of "Other Expenses."

As of December 31, 2004 the Milwaukee property, valued at \$1.4 million, had been moved to Other Real Estate pending its sale.

#### 7. Commitments and Contingencies

At December 31, 2004, the Bank was obligated under noncancelable leases for premises and equipment with

terms ranging from one to approximately seven years. These leases provide for increased rentals based upon increases in real estate taxes, operating costs, or selected price indices.

Rental expense under operating leases for certain operating facilities, warehouses, and data processing and office equipment (including taxes, insurance and maintenance when included in rent), net of sublease rentals, was \$4 million for each of the years ended December 31, 2004 and 2003. Certain of the Bank's leases have options to renew.

Future minimum rental payments under noncancelable operating leases and capital leases, net of sublease rentals, with terms of one year or more, at December 31, 2004, were (in thousands):

	Operating	Capital
2005	\$ 745	\$ 132
2006	647	132
2007	374	132
2008	268	22
2009	274	—
Thereafter	467	—
	\$ 2,775	418
Amount representing interest		54
Present value of net minimum lease payments		\$ 364

At December 31, 2004, the Bank, acting on its own behalf, entered into other commitments and long-term obligations extending through the year 2005 totaling \$61.7 million. As of December 31, 2004, \$11.8 million of these commitments was recognized. Purchases of \$16.9 million and \$4.1 million were made against these commitments during 2004 and 2003, respectively. These commitments represent services related to a new Detroit branch building that will be completed in 2005.

Under the Insurance Agreement of the Federal Reserve Banks dated as of March 2, 1999, each of the Reserve Banks has agreed to bear, on a per incident basis, a pro rata share of

losses in excess of one percent of the capital paid-in of the claiming Reserve Bank, up to 50 percent of the total capital paid-in of all Reserve Banks. Losses are borne in the ratio that a Reserve Bank's capital paid-in bears to the total capital paid-in of all Reserve Banks at the beginning of the calendar year in which the loss is shared. No claims were outstanding under such agreement at December 31, 2004 or 2003.

The Bank is involved in certain legal actions and claims arising in the ordinary course of business. Although it is difficult to predict the ultimate outcome of these actions, in management's opinion, based on discussions with counsel, the aforementioned litigation and claims will be resolved without material adverse effect on the financial position or results of operations of the Bank.

## 8. Retirement and Thrift Plans

### Retirement Plans

The Bank currently offers two defined benefit retirement plans to its employees, based on length of service and level of compensation. Substantially all of the Bank's employees participate in the Retirement Plan for Employees of the Federal Reserve System ("System Plan") and the Benefit Equalization Retirement Plan ("BEP"). In addition, certain Bank officers participate in the Supplemental Employee Retirement Plan ("SERP").

The System Plan is a multi-employer plan with contributions fully funded by participating employers. Participating employers are the Federal Reserve Banks, the Board of Governors of the Federal Reserve System, and the Office of Employee Benefits of the Federal Reserve Employee Benefits System. No separate accounting is maintained of assets contributed by the participating employers. The FRBNY acts as a sponsor of the Plan for the System and the costs associated with the Plan are not redistributed to the Bank. The Bank's projected benefit obligation and net pension costs for the BEP and the SERP at December 31, 2004 and 2003 and for the years then ended, are not material.

### Thrift Plan

Employees of the Bank may also participate in the defined contribution Thrift Plan for Employees of the Federal Reserve System ("Thrift Plan"). The Bank's Thrift Plan contributions totaled \$5.6 million and \$5.9 million for the years ended December 31, 2004 and 2003, respectively, and are reported as a component of "Salaries and other benefits."

## 9. Postretirement Benefits other than Pensions and Postemployment Benefits

### Postretirement Benefits other than Pensions

In addition to the Bank's retirement plans, employees who have met certain age and length of service requirements are eligible for both medical benefits and life insurance coverage during retirement.

The Bank funds benefits payable under the medical and life insurance plans as due and, accordingly, has no plan assets. Net postretirement benefit cost is actuarially determined using a January 1 measurement date.

Following is a reconciliation of beginning and ending balances of the benefit obligation (in millions):

	2004	2003
Accumulated postretirement benefit obligation at January 1	\$ 106.5	\$ 85.2
Service cost-benefits earned during the period	1.9	1.9
Interest cost of accumulated benefit obligation	5.9	5.5
Actuarial loss	2.3	19.1
Curtailment gain	(1.2)	-
Contributions by plan participants	1.2	0.9
Benefits paid	(6.6)	(6.1)
Plan amendments	(13.0)	-
<b>Accumulated postretirement benefit obligation at December 31</b>	<b>\$ 97.0</b>	<b>\$ 106.5</b>

At December 31, 2004 and 2003, the weighted-average discount rate assumptions used in developing the postretirement benefit obligation were 5.75 percent and 6.25 percent, respectively.

Following is a reconciliation of the beginning and ending balance of the plan assets, the unfunded postretirement benefit obligation, and the accrued postretirement benefit cost (in millions):

	2004	2003
Fair value of plan assets at January 1	\$ -	\$ -
Actual return on plan assets	-	-
Contributions by the employer	5.4	5.2
Contributions by plan participants	1.2	0.9
Benefits paid	(6.6)	(6.1)
<b>Fair value of plan assets at December 31</b>	<b>\$ -</b>	<b>\$ -</b>
Unfunded postretirement benefit obligation	\$ 97.0	\$ 106.5
Unrecognized net curtailment gain	2.2	-
Unrecognized prior service cost	14.4	18.5
Unrecognized net actuarial loss	(44.1)	(45.0)
<b>Accrued postretirement benefit costs</b>	<b>\$ 69.5</b>	<b>\$ 80.0</b>

Accrued postretirement benefit costs are reported as a component of "Accrued benefit costs."

For measurement purposes, the assumed health care cost trend rates at December 31 are as follows:

	2004	2003
Health care cost trend rate assumed for next year	9.00%	10.00%
Rate to which the cost trend rate is assumed to decline (the ultimate trend rate)	4.75%	5.00%
Year that the rate reaches the ultimate trend rate	2011	2011

Assumed health care cost trend rates have a significant effect on the amounts reported for health care plans. A one percentage point change in assumed health care cost trend rates would have the following effects for the year ended December 31, 2004 (in millions):

	One Percentage Point Increase	One Percentage Point Decrease
Effect on aggregate of service and interest cost components of net periodic postretirement benefit costs	\$ 1.3	\$ (0.9)
Effect on accumulated postretirement benefit obligation	12.2	(10.0)

The following is a summary of the components of net periodic postretirement benefit costs for the years ended December 31 (in millions):

	2004	2003
Service cost-benefits earned during the period	\$ 1.9	\$ 1.9
Interest cost of accumulated benefit obligation	5.9	5.5
Amortization of prior service cost	(2.6)	(2.5)
Recognized net actuarial loss	2.1	1.1
<b>Total periodic expense</b>	<b>\$ 7.3</b>	<b>\$ 6.0</b>
Curtailment gain	(12.4)	-
<b>Net periodic postretirement benefit costs</b>	<b>\$ (5.1)</b>	<b>\$ 6.0</b>

At December 31, 2004 and 2003, the weighted-average discount rate assumptions used to determine net periodic postretirement benefit costs were 6.25 percent and 6.75 percent, respectively.

Net periodic postretirement benefit costs are reported as a component of "Salaries and other benefits."

A plan amendment that modified the credited service period eligibility requirements created curtailment gains. The recognition of special termination losses is primarily the result of enhanced retirement benefits provided to employees during the restructuring described in footnote 10. Because the special termination loss is less than \$50,000, the amount is not displayed in the tables above. The curtailment gain associated with restructuring programs announced in 2004 that are described in footnote 10 will be offset by the unrecognized actuarial losses and prior service gains. As a result, an unrecognized net curtailment gain will be recorded in 2005 when the affected employees terminate employment.

The Medicare Prescription Drug, Improvement and Modernization Act of 2003 (the "Act") was enacted in December 2003. The Act established a prescription drug benefit under Medicare ("Medicare Part D") and a federal subsidy to sponsors of retiree health care benefit plans that provide benefits that are at least actuarially equivalent to Medicare Part D. Following the guidance of the Financial Accounting Standards Board, the Bank elected to defer recognition of the financial effects of the Act until further guidance was issued in May 2004.

Benefits provided to certain participants are at least actuarially equivalent to Medicare Part D. The estimated effects of the subsidy, retroactive to January 1, 2004, are reflected in actuarial loss in the accumulated postretirement benefit obligation and net periodic postretirement benefit costs.

Following is a summary of the effects of the expected subsidy (in millions):

	2004	
Decrease in the accumulated postretirement benefit obligation	\$	12.4
Decrease in the net periodic postretirement benefit costs	\$	1.6
Expected benefit payments:		
	Without Subsidy	With Subsidy
2005	\$ 6.2	\$ 6.2
2006	6.5	6.0
2007	6.5	6.0
2008	6.6	6.0
2009	6.8	6.2
2010-2014	35.3	31.8
<b>Total</b>	<b>\$ 67.9</b>	<b>\$ 62.2</b>

### Postemployment Benefits

The Bank offers benefits to former or inactive employees. Postemployment benefit costs are actuarially determined using a December 31, 2004 measurement date and include the cost of medical and dental insurance, survivor income, and disability benefits. For 2004, the Bank changed its practices for projecting postemployment costs and used a 5.25 percent discount rate and the same health care trend rates as were used for projecting postretirement costs. Costs for 2003, however, were projected using the same discount rate and health care trend rates as were used for projecting postretirement costs. The accrued postemployment benefit costs recognized by the Bank at December 31, 2004 and 2003, were \$12 million and \$13 million, respectively. This cost is included as a component of "Accrued benefit costs." Net periodic postemployment benefit costs included in 2004 and 2003 operating expenses were \$1 million and \$2 million, respectively.

### 10. Business Restructuring Charges

In 2003, the Bank announced plans for restructuring to streamline operations and reduce costs, including consolidation of check operations and staff reductions in various functions of the Bank. In 2004, additional consolidation and restructuring initiatives were announced in the check operation. These actions resulted in the following business restructuring charges and asset impairment costs:

Major categories of expense (in millions):

	Total Est. Costs	Acc. Liab. 12/31/03	Total Charges	Total Paid	Acc. Liab. 12/31/04
Employee separation	\$ 8.0	\$ 6.7	\$ 1.3	\$ 4.2	\$ 3.8
Contract termination	0.6	0.6	—	—	0.6
<b>Total</b>	<b>\$ 8.6</b>	<b>\$ 7.3</b>	<b>\$ 1.3</b>	<b>\$ 4.2</b>	<b>\$ 4.4</b>

Employee separation costs are primarily severance costs related to identified staff reductions of approximately 334, including 262 staff reductions related to restructuring announced in 2003. These costs are reported as a component of "Salaries and other benefits." Contract termination costs include the charges resulting from terminating existing lease and other contracts and are shown as a component of "Other expenses."

Costs associated with the write-downs of certain Bank assets, including software, furniture, and equipment are discussed in footnote 6. Costs associated with enhanced pension benefits for all Reserve Banks are recorded on the books of the FRBNY as discussed in footnote 8. Costs associated with enhanced postretirement benefits are disclosed in footnote 9.

Future costs associated with the restructuring that are not estimable and are not recognized as liabilities will be incurred in 2005.

The Bank anticipates substantially completing its announced plans by March 2005.

## OUR MISSION

The Federal Reserve Bank of Chicago is one of 12 regional Reserve Banks across the United States that, together with the Board of Governors in Washington, D.C., serve as the nation's central bank. The role of the Federal Reserve System, since its establishment by an act of Congress passed in 1913, has been to foster a strong economy, supported by a stable financial system.

To this end, the Federal Reserve Bank of Chicago participates in the formulation and implementation of national monetary policy; supervises and regulates state-member banks, bank holding companies and foreign bank branches; and provides financial services to depository institutions and the U.S. government. Through its head office in Chicago, branch in Detroit, regional office in Des Moines, and facility in Bedford Park, Ill., the Federal Reserve Bank of Chicago serves the Seventh Federal Reserve District, which includes major portions of Illinois, Indiana, Michigan and Wisconsin, plus all of Iowa.

## OUR VISION

- Further the public interest by fostering a sound economy and stable financial system
- Provide products and services of unmatched value to those we serve
- Set the standard for excellence in the Federal Reserve System
- Work together, value diversity, communicate openly, be creative and fair
- Live by our core values of integrity, respect, responsibility and excellence

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